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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT FOR A PROPOSED LOAN

IN THE AMOUNT OF EUR 37.4 MILLION  
(US\$50 MILLION EQUIVALENT)

TO

BOSNIA AND HERZEGOVINA

FOR THE

BUSINESS ENVIRONMENT DEVELOPMENT POLICY LOAN

September 15, 2014

Trade and Competitiveness Global Practice (GTCDR)  
South East Europe Country Unit (ECCU 4)  
Europe and Central Asia (ECA)

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BOSNIA AND HERZEGOVINA  
FISCAL YEAR  
*January 1 – December 31*

**CURRENCY EQUIVALENTS**

(Exchange Rate Effective as of September 12, 2014)

Currency Unit = Convertible Mark (BAM)

BAM 1.51281 = US\$1.00

US\$ 0.66102 = BAM 1.00

**ABBREVIATIONS AND ACRONYMS**

BH	Bosnia and Herzegovina
BAC	Business Environment Adjustment Credit
BAM	Convertible Mark
BEEPS	Business Environment and Enterprise Performance Survey
BHAS	Agency for Statistics of Bosnia and Herzegovina
BLSE	Banja Luka Stock Exchange
CBBH	Central Bank of Bosnia and Herzegovina
CAD	Current Account Deficit
CCS	Compliance Cost Savings
CPS	Country Partnership Strategy
CFAA	Country Financial Accountability Assessment
DB	Doing Business
EC	European Commission
EEZ	European Economic Union (Europska ekonomska zajednica)
EIA	Environmental Impact Assessment
ESW	Economic Sector Work
EU	European Union
EUD	Delegation of the European Union
FBH	Federation of Bosnia and Herzegovina
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GNP	Gross National Product
HBS	Household Budget Survey
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFC	International Finance Corporation
IFI	International Financial Institutions
IMF	International Monetary Fund
INTOSAI	International Organization of Supreme Audit Institutions
IPA	Instrument for Pre-Accession
JSAN	Joint Staff Advisory Note
LDP	Letter of Development Policy
LLC	Limited Liability Company
MDGs	Millennium Development Goals
MoAFW	Ministry of Agriculture, Forestry and Water Management in Republika Srpska
MoAWF	Ministry of Agriculture, Water Management and Forestry in Federation BH
MoEMI	Ministry of Energy, Mining and Industry in Federation BH
MoERC	Ministry of Economic Relations and Regional Cooperation in Republika Srpska

MoF	Ministry of Finance at the entity level
MoFT	Ministry of Finance and Treasury
MoJ	Ministry of Justice
MoSPCEE	Ministry of Trade and Tourism, and Ministry of Spatial Planning, Civic Engineering and Ecology in Republika Srpska
MoT	Ministry of Trade in Federation BH
MoTT	Ministry of Trade and Tourism in Republika Srpska
MoU	Memorandum of Understanding
MTEF	Medium-Term Expenditure Framework
NPL	Non Performing Loans
OBI	Open Budget Index
OSS	One-Stop Shop
PFM	Public Financial Management
PPA	Public Procurement Agency
PPL	Public Procurement Law
PRB	Procurement Review Body
REER	Real Effective Exchange Rate
RS	Republika Srpska
SAI	Supreme Audit Institution(s)
SASE	Sarajevo Stock Exchange
SBA	Stand-By Arrangement
SDR	Special Drawing Rights
SEA	Strategic Environmental Assessment
SECO	Swiss State Secretariat for Economic Affairs
SEE	South East Europe
Sida	Swedish International Development Cooperation Agency
SOE	State-Owned Enterprise
TA	Technical Assistance
T-bills	Treasury Bills
TSA	Treasury Single Account
USAID	United States Agency for International Development
VAT	Value-Added Tax
WBG	World Bank Group

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The World Bank greatly appreciates the close collaboration of the state and entities governments in the preparation of this Development Policy Loan (DPL). The Development Policy Loan was prepared by the World Bank Group team consisting of Wolfgang Fengler (TTL), Ruvejda Aliefendic, Simon Davies, Senka Eminagic, Sandra Hlivnjak, and Tarik Sahovic. The core team also included Alexandru Cojocaru, Nichola Dyer, Gallina Andronova Vincelette, Caterina Ruggeri Laderchi, Lamija Marijanovic, Esmá Kreso, Maria Davalos, Lidia Ceriani, Jose Janeiro, Maiada Kassem, Elena Kantarovich, Nejme Kotere, Amanda Schneider, Charlotte Wu Homme, and Lejla Zaimovic.

SUMMARY OF PROPOSED LOAN AND PROGRAM  
*BOSNIA AND HERZEGOVINA*  
*DEVELOPMENT POLICY LOAN*

Borrower	Bosnia and Herzegovina
Implementation Agency	Ministry of Finance and Treasury BH, Ministry of Finance of Republika Srpska, Ministry of Finance of Federation BH.
Financing Data	IBRD loan of Euro 37.4 million (US\$50 million equivalent)
Operation Type	Development Policy Loan
Pillars of the Operation And Program Development Objective(s)	<p>The development objective is to improve BH's business environment through facilitating business start-up, streamlining investment procedures in inspections and construction, and simplifying processes of cross-border trading.</p> <p>This Operation is designed around three pillars: 1) Facilitating Business Start-up, 2) Streamlining Investment Procedures in Inspections and Construction; and 3) Simplifying Processes of Cross-Border Trading.</p>
Result Indicators	<p><b>Pillar 1: Facilitating Business Start-up</b> (at end Q1 2015)</p> <p>FBH:</p> <ul style="list-style-type: none"> <li>• Business registration cost and time reduced by up to 20 percent</li> <li>• Specific notary tariffs for start-up businesses reduced by 15 percent</li> </ul> <p>RS:</p> <ul style="list-style-type: none"> <li>• Incorporation capital for newly established Limited Liability Company is 1 BAM.</li> <li>• Tariffs on notary reward reduced by 30 percent.</li> <li>• Business registration procedures reduced to 5 steps (from 11)</li> <li>• Business registration time reduced to 3 days (from 23)</li> </ul> <p><b>Pillar 2: Streamlining Investment Procedures in Inspections and Construction</b> (at end Q1 2015):</p> <p>FBH:</p> <ul style="list-style-type: none"> <li>• Increased effectiveness of inspections by 15 percent</li> <li>• Reduced cost for businesses by at least 10 percent following introduction of risk based inspections</li> </ul> <p>RS:</p> <ul style="list-style-type: none"> <li>• Time required to obtain individual permits reduced to a maximum 15 days</li> <li>• Direct and indirect cost savings resulting from the new law est. at 17 mln BAM annually</li> </ul> <p><b>Pillar 3: Simplifying Processes of Cross-Border Trading</b> (at end Q1 2015):</p> <ul style="list-style-type: none"> <li>• Reduction of direct and indirect costs to obtain licenses, permits and approvals, related to import/export procedures for seven key exports (wood; fruits and vegetables; meat; basic materials; dairy; electrical appliances and metal), by a one-off 5 percent (2 mln BAM) over both entities.</li> </ul>
Overall risk rating	<b>Substantial.</b> Complex governance structures and on-going political tensions indicate a substantial risk to the medium-term success of this operation. These are mitigated by strong engagement across the country, including through the ongoing technical assistance by the World Bank and IFC in both entities, backed by the robust program of reforms.
Operation ID	P146740

## PROGRAM DOCUMENT FOR A PROPOSED LOAN TO BOSNIA AND HERZEGOVINA

### 1. INTRODUCTION AND COUNTRY CONTEXT

1. **This program document describes the proposed Development Policy Loan (DPL) to Bosnia and Herzegovina (BH) in the amount of Euro 37.4 million (US\$50 million equivalent).** This operation supports critical reforms to improve the country's business environment in both entities: the *Federation BH and Republika Srpska*. It complements the existing IMF Stand-By Arrangement (SBA) and is also part of a broader engagement of the World Bank Group to improve BH's competitiveness and create jobs.
2. **The DPL takes into account the country's complex institutional structure.** BH consists of two entities: The *Federation BH* (FBH), which is further decentralized into ten cantons, and *Republika Srpska* (RS), with central functions such as foreign policy and defense the responsibility of the State level. In addition, Brcko District (BD) was established as a self-governing administrative unit in 1999. This institutional framework means that important policy reforms can advance only if the entities support and implement them. The political stalemates that characterize BH's institutional context call for flexibility with respect to the design of this Development Policy Loan.
3. **BH's economy was recovering prior to the recent floods.** The economy grew by 1.8 percent in 2013, following a recovery in exports and, prior to the floods, was projected to grow by 2 percent in 2014. A stable exchange rate (currency board), low inflation and a relatively robust financial sector have been conducive in maintaining a stable macroeconomic environment despite emerging vulnerabilities due to the rising of Non-Performing Loans (NPLs). BH remains dependent on capital inflows, especially remittances from other parts of Europe to finance a large current account deficit. The country's agriculture exports have declined as trade with Croatia has deteriorated due to its application of EU rules and regulations. These developments demonstrate the importance for BH to upgrade its systems for trading across borders, inspections and sanitation for facilitating the flow of goods and services toward international markets, especially to the EU.
4. **The devastating floods, which occurred in May 2014 and in early August 2014, have added to the social and economic challenges of BH.** Preliminary estimates place the combined damages and losses in at close to 15 percent of GDP. As a result, the economy is expected to contract by 0.7 percent in 2014, and social impact has been even greater.<sup>1</sup> The floods are also putting a strain on public finances and the fiscal balance is expected to deteriorate from -2 percent to -4.5 percent of GDP. With few available domestic resources, the new financing gap will need to be closed with donor resources. As a response to the floods a joint Donors' conference for both BH and Serbia was organized in Brussels on July 16, 2014. Donors' pledges of Euro 809 million will cover short-term reconstruction needs, of which the World Bank provided US\$ 100 million (Euro 77 million) through a Floods

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<sup>1</sup> For details, see Government of Bosnia and Herzegovina. 2014. "Bosnia and Herzegovina floods 2014: Recovery Needs Assessment."

Emergency Recovery Project. The floods of August 2014 have added additional suffering and need for the government to re-allocate resources for social and economic recovery.

5. **More than ever, BH needs new sources of growth and reforms to improve the business environment to unleash the country's growth potential.** The domestic market is small and neighboring countries are now part of the EU or its accession process. The riots of February 2014 have only reinforced the need to create jobs which only happens if local and international businesses have the confidence to invest. However, BH is rated one of the least favorable places to do business among the neighboring countries (rank 131 in *Doing Business 2014* out of 189 economies). This ranking indicates the critical need to accelerate reform in key areas such as *Starting a Business*, *Dealing with Construction Permits*, and *Trading Across Borders*.
6. **This operation is helping to address BH's deep structural imbalances to achieve higher economic growth and reduce unemployment.** After the end of the war in 1995, BH experienced a robust recovery for more than a decade. Before the global crisis, poverty also declined from 18 percent (2004) to 14 percent (2007) but some of these gains may have been reversed, especially due to the recent floods. Since 2007, the country has experienced low growth, which by 2013 translated into record high unemployment of 27.5 percent, with unemployment among women reaching 29 percent. BH also has an extremely low employment rate of 31.6 percent.
7. **The measures supported by this loan are significant.** Since early 2013, both entities have accelerated ongoing reforms in the business environment, particularly in the construction sector and by simplifying the business registration process which this operation would reinforce. Building on ongoing engagements by the IFC and the World Bank, this operation has been supporting both entities in carrying out critical reforms in three pillars:
  - *Pillar I. Facilitating Business Start-up:* simplify and reduce procedures and cost for business registration, reduce notary tariffs, and introduce modern corporate management practices in limited liabilities companies.
  - *Pillar II. Streamlining Investment Procedures in Inspections and Construction:* simplify existing inspections and streamline the process to obtain construction permits.
  - *Pillar III. Simplifying processes of cross-border trading:* simplify and reduce the number of documents, timeline and costs for licensing, permits and approvals related to import/export procedures in selected sectors in both entities.
8. **The proposed DPL has been developed jointly by the World Bank and IFC.** The operation builds on an extensive technical assistance program of the IFC, that covers the key areas of this operation, including trade facilitation, construction sector regulations, and preparations for the new company law and decree on notaries' fees. Other elements of the reform program, such as improvement to the inspections law and the business registration law are supported by World Bank technical assistance. The World Bank and IFC will jointly monitor and support the implementation of the next phase of reforms in both entities.



## 2. MACROECONOMIC POLICY FRAMEWORK

### 2.1 RECENT ECONOMIC DEVELOPMENTS

9. **Following negative growth in 2012, economic growth returned in 2013, supported by exports.** Industrial production grew by 7.1 percent led by a strong performance from the manufacturing sector, which was up by 17.1 percent. This revival was supported by export growth, with goods exports up by 6.6 percent in the year. Energy exports led the way (up 34 percent), followed by capital goods (up 12.5 percent), and consumer goods (durable up 10.6 percent, non-durable up 7.3 percent). Non-energy intermediate goods production declined, suggesting that the increase in the manufacture of intermediate goods was largely serving BH's own manufacturing sector. Overall, the economy grew by 1.8 percent in 2013 but due to the floods it is expected to contract by 0.7 percent in 2014 (Table 1).
10. **The currency board continued to support monetary stability and inflation remained low into 2013.**<sup>2</sup> Inflation declined from around 2 percent in 2012 (with core inflation below 1 percent) to turn negative (-0.1 percent) in 2013. International reserves, which are crucial to maintaining monetary stability under the currency board, remained at a comfortable level during 2013, at around 5 months of imports. As a result of a stable nominal exchange rate and lower inflation in BH than in major trading partners, the real effective exchange rate (REER) depreciated slightly during 2013 (-0.6 percent y-o-y). This suggests that the price competitiveness of the domestic economy increased compared to its major trading partners.
11. **The external position improved during 2013, after two years of large current account deficits.** The trade deficit declined from 32.8 percent of GDP in 2012 to 29.6 percent of GDP in 2013 thanks to higher exports of electricity and goods. Total exports of goods increased by 8.7 percent in compared to 2012, reflecting some improvement in external demand. At the same time, goods imports declined by 1.5 percent. A combination of foreign direct investments (FDI), remittances, grants and foreign credit financed the Current Account Deficit (CAD). FDI investment reached 1.8 percent of GDP in the first half of the year, but then disappointed in the second half of the year, reaching only 1.9 percent over the whole year. The remainder of the CAD was financed by *Other Investments* (assets and liabilities of residents), and external borrowing (including from the IMF).
12. **Remittances continue to be an important source of financial flows for BH.** Remittances held up during the crisis and remained a major part of the foreign financing, partly due to increased economic integration with the EU. In 2013, remittances amounted to 15.8 percent of GDP (down from 16.5 percent of GDP in 2012)<sup>3</sup>. Remittances have remained fairly stable over recent years although their trend expressed as a share of GDP has been on a slow downward path for a couple of years.
13. **While the banking sector remained stable and reduced its reliance on foreign financing, non-performing loans (NPLs) continued to grow during 2013.** Many of the foreign-owned

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<sup>2</sup> The BH convertible mark (BAM) is managed by a currency board with a fixed exchange rate at a rate of BAM 1.96: Euro 1.

<sup>3</sup> Remittances also include workers' compensation and private current transfers (e.g. pensions received from abroad).

banks, which dominate the banking system, gradually deleveraged. Some of the largest banks in BH contracted their balance sheets to repay deposits or loans from their parent banks. Banks' foreign liabilities, which accounted for 31 percent of total bank liabilities at end-2008 dropped to 17.7 percent of total bank liabilities at end-2012 and have continued declining during 2013 reaching 14.7 percent by the end of the year. The quality of credit portfolios deteriorated for the fourth year in a row alongside the stagnant economy. NPLs accounted for 13.5 percent of total loans in 2012 and reached 15.1 percent by end-December, 2013.

**14. BH faced significant challenges maintaining a prudent fiscal policy due to the global financial crisis.** The authorities began fiscal consolidation in 2010 and reduced the deficit to 2.0 percent in 2013 (in line with the IMF program requirements) from 5.5 percent of GDP in 2009. This consolidation was necessary due to reduced revenues (mainly due to growing VAT refunds and tax arrears) and lack of financing. In 2013, revenues fell by 1.3 percent of GDP (Table 1), partly due to increased tax refunds. To maintain a sustainable fiscal stance in the face of declining revenues, measures were taken to reduce expenditures. Efforts to contain current spending in 2013 were weak with public sector wages and social benefits together amounting to 27 percent of GDP. Total expenditure declined by 1.9 percent of GDP in 2013. Public expenditures were, and remain, excessively concentrated in non-growth enhancing areas.

**15. Public debt decreased in 2013 and is considered sustainable.** Total public debt declined from 44.6 percent of GDP (2012) to 42.5 percent of GDP (2013). Public debt in 2013 consisted of external debt of 28.1 percent of GDP and domestic debt of 14.5 percent of GDP. External public debt is predominately on concessional terms to International Financial Institutions (IFIs).

Table 1: Key Economic Indicators and medium term outlook based on rapid recovery from flooding

	2011	2012	2013 Est.	2014 Proj.	2015	2016	2017
GDP Growth	1.0	-1.1	1.8	-0.7	3.5	3.7	4.0
Inflation	3.7	2.0	-0.1	1.1	1.5	1.8	2.0
Unemployment rate	27.6	28.0	27.5	...	...	...	...
	<i>in percent of GDP</i>						
Consumption	106.1	106.2	102.8	102.4	103.0	102.5	101.8
Gross capital formation	18.1	18.1	18.2	20.2	19.7	18.8	18.7
National Savings	9.0	8.9	12.8	8.0	11.0	11.9	12.5
Saving-Investment balance	-9.1	-9.2	-5.4	-12.2	-8.7	-6.9	-6.2
<b>Fiscal Sector</b>							
Revenue	45.9	46.3	45.1	45.1	45.3	45.5	45.6
Expenditure	48.8	48.9	47.0	49.6	48.0	46.8	46.4
Fiscal Balance	-2.8	-2.7	-1.9	-4.5	-2.7	-1.3	-0.8
Public debt	40.8	44.6	42.5	46.2	46.0	44.6	42.2
<b>External sector</b>							
Current Account Balances	-9.9	-9.7	-5.4	-10.7	-8.6	-6.9	-6.2
External Debt	48.9	52.2	50.8	54.6	54.2	51.6	47.7
FDI (Net)	2.6	2.1	1.9	1.9	2.3	2.3	2.3
Gross Official reserves (in months of imports)	5.4	5.6	5.4	5.4	5.2	4.9	4.7

Source: IMF, authorities and World Bank staff estimations

## 2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

16. **Prior to the floods, economic growth in BH was expected to pick up slowly in the medium term.** Growth reached 1.8 percent in 2013, driven largely by exports and was projected to increase gradually to 3.5 percent by 2015, based on increased exports, continued stable inflows of remittances, and some progress in implementing structural reforms.
17. **The medium-term growth potential of BH's economy is constrained by two main structural factors.** The first is a weak business environment that still requires substantial reforms, and is hampering investment and growth. The second is a fiscal policy that remains focused on income redistribution (though not necessarily to the poorest) rather than growth. Strengthening public financial management, including both debt management policies and practices, as well as focusing spending on growth-enhancing areas, will be an integral part of boosting economic growth. To unleash the economy's growth potential, BH's authorities will need both to improve the business environment and re-orient public spending towards growth-enhancing investment.
18. **Ensuring the sustainability of the fiscal framework is the key to macro-economic stability.** Prior to the floods, fiscal consolidation was expected to continue gradually over the medium term: from a deficit of 2.7 percent of GDP in 2012 to a balanced budget in 2018. Fiscal policy in 2013 targeted a reduction in the general government deficit to 2 percent. The latest Global Fiscal Framework for 2014-2016 (which determines the overall spending envelope and revenue share for the budget of the Institutions of BH), is consistent with the medium term fiscal objectives.
19. **Despite the broadly positive medium-term outlook, financing expenditures in 2014 was likely to prove challenging for both entities, even before the floods increased expenditure needs.** Following lower-than-forecast revenue performance in 2013, both entities took a prudent approach to revenue estimation and based their preliminary budgets on revenue forecasts below those of the IMF. Both entities estimate that they will be able to roll over short-term debt, but are cautious about issuing additional short-term debt to the banking sector. In the FBH, it is not clear that there would be significant demand from the banking sector for much additional public debt, with some banks reportedly reaching their public debt exposure limits. The remaining financing gap for 2014 (prior to the floods) was expected to be closed through external sources, mainly the IMF and World Bank (Table 2).
20. **However, the recent floods have considerably changed the economic outlook for 2014.** Preliminary estimations from the damages and losses associated with the floods put the costs of the floods at the equivalent of nearly 15 percent of GDP in damages (9.3 percent of GDP) and losses (5.6 percent) in 2014 in BH. This amounts to around \$1.8 billion of damages and \$1.1 billion of losses. The hardest hit economic sectors were agriculture, transport and productive activities. As a result, the economy of BH is now expected to contract by 0.7 percent in 2014. The trade deficit is likely to come under pressure, widening to 34.3 percent of GDP in 2014 while the current account deficit is projected to increase from the baseline 7.8 to 10.7 percent of GDP in 2014. In addition, simulations suggest that an additional 4,134

to 18,602 families (0.4 to 1.8 percent of households) are estimated to have fallen below the poverty threshold as a result of the floods.<sup>4</sup>

Table 2: Pre-flood projected General Government and Entity 2014 Budgets

	BH		FBH	RS
	% GDP	BAM	BAM	BAM
<b>Revenue</b>	<b>46.5</b>	<b>12646</b>	<b>7409.5</b>	<b>4030.9</b>
Taxes	23	6093.4	3314.5	1839.1
Direct taxes	3.6	951.3	528.3	398.8
Indirect taxes	19.4	5109.7	2774.7	1420.7
Other taxes	0	32.4	11.4	19.6
Social security contributions	15.4	4331.7	2822.6	1471.2
Grants	2.5	568.7	379.8	185.6
Other revenue	5.6	1652.3	892.6	534.9
<b>Expenditure</b>	<b>48</b>	<b>13024.2</b>	<b>7728.8</b>	<b>4088.9</b>
Expense	41.3	11245.7	6558	3571.1
Compensation of employees	12.3	3367.9	1722	917.4
Use of goods and services	10.6	2883.2	1605.1	996.8
Social benefits	14.4	3948.8	2602.6	1305.6
Interest	0.9	237	119.6	116.1
Subsidies	1.4	361.4	237.2	111.6
Other expense	1.6	463.2	271.5	123.5
Net acquisition of nonfinancial assets	6.7	1778.6	1170.8	517.8
Acquisition of nonfinancial assets	6.9	1852	1181.5	579.7
Foreign financed capital spending	4.1	1110.3	846.4	263.1
Domestically financed capital spending	2.8	741.7	335.1	316.6
Disposal of nonfinancial assets	0.1	73.4	10.7	62
<b>Gross / Net Operating Balance (revenue minus expense)</b>	<b>4.8</b>	<b>1400.4</b>	<b>851.5</b>	<b>459.8</b>
<b>Net lending/borrowing (revenue minus expenditure)</b>	<b>-1.4</b>	<b>-378.2</b>	<b>-319.3</b>	<b>-58</b>
Net acquisition of financial assets	0.4	105.6	-52.3	128.2
Net incurrence of liabilities	-0.1	-11.2	-63.6	21.7
<b>Financing gap</b>	<b>-1.9</b>	<b>-495.0</b>	<b>-330.6</b>	<b>-164.5</b>
<b>Identified financing</b>	<b>1.9</b>	<b>495.0</b>		
IMF	1.7	452.4		
WB	0.2	42.6		

<sup>4</sup> The share of families living in poverty according to the national methodology (based on the EHBS data for 2011 and the absolute poverty line BAM 238). The impact roughly translates into 12,700 to 57,000 new individuals entering into poverty as the result of floods. Preliminary estimates, based on the World Bank's poverty methodology, are from the forthcoming report developed jointly by the World Bank and the Agency for Statistics of Bosnia and Herzegovina, the Institute for Statistics of FB&H, and the Republic of Srpska Institute of Statistics.

Source: IMF. Note: These are the official budget numbers and reflect the situation prior to the floods. The sum of FBH and RS budgets is not identical to BH due to Brcko District and the State's own budget.

21. **The fiscal impact of the floods is likely to be considerable.** The floods are expected to put further strain on public finances, raising the fiscal deficit from a baseline of 2 percent of GDP to 4.5 percent in 2014. The entity governments started to amend their budgets for 2014, as revenues are expected to fall and spending needs are increased as a result of the recent floods. Nonetheless, with sufficient donor financing, the deficit is expected to remain contained over the medium term (Table 3).

Table 3: General government state of operations 2011-2017 (% GDP)

	2011	2012	2013	2014	2015	2016	2017
			Est.		Proj.		
<b>Revenue</b>	<b>45.9</b>	<b>46.3</b>	<b>45.1</b>	<b>45.1</b>	<b>45.3</b>	<b>45.5</b>	<b>45.6</b>
Taxes	23.0	23.0	22.1	21.6	21.9	21.9	21.8
Direct taxes	3.5	3.6	3.6	3.3	3.4	3.5	3.5
Indirect taxes	19.4	19.4	18.4	18.2	18.4	18.3	18.2
Other taxes	0.1	0.0	0.1	0.1	0.1	0.1	0.1
Social security contributions	15.7	15.8	15.5	15.3	15.5	15.7	15.7
Grants	2.1	2.2	2.4	2.5	2.6	2.7	2.8
Other revenue	5.1	5.3	5.1	5.7	5.3	5.3	5.3
<b>Expenditure</b>	<b>48.8</b>	<b>48.9</b>	<b>47.0</b>	<b>49.6</b>	<b>48.0</b>	<b>46.8</b>	<b>46.4</b>
<b>Expense</b>	<b>42.5</b>	<b>42.6</b>	<b>40.7</b>	<b>41.7</b>	<b>40.3</b>	<b>39.7</b>	<b>39.3</b>
Compensation of employees	12.9	13.0	12.2	12.4	11.8	11.8	11.9
Use of goods and services	10.5	10.8	10.4	10.9	10.4	10.3	10.3
Social benefits	14.6	14.5	14.3	14.5	14.1	13.8	13.7
Interest	0.6	0.8	0.7	0.8	1.0	1.0	0.8
Subsidies	1.7	1.6	1.4	1.3	1.3	1.2	1.1
Other expense	2.1	1.9	1.7	1.8	1.7	1.6	1.5
<b>Net acquisition of nonfinancial assets</b>	<b>6.3</b>	<b>6.3</b>	<b>6.4</b>	<b>7.9</b>	<b>7.7</b>	<b>7.1</b>	<b>7.1</b>
Acquisition of nonfinancial assets	6.4	6.5	6.5	8.2	7.9	7.3	7.3
Foreign financed capital spending	3.6	3.3	4.2	5.6	5.4	4.7	4.7
Domestically financed capital spending	2.7	3.2	2.3	2.6	2.5	2.6	2.6
Disposal of nonfinancial assets	0.1	0.2	0.1	0.3	0.2	0.2	0.2
<b>Gross / Net Operating Balance (revenue minus expense)</b>	<b>3.4</b>	<b>3.7</b>	<b>4.4</b>	<b>3.4</b>	<b>5.0</b>	<b>5.8</b>	<b>6.3</b>
<b>Fiscal balance</b>	<b>-2.8</b>	<b>-2.7</b>	<b>-1.9</b>	<b>-4.5</b>	<b>-2.7</b>	<b>-1.3</b>	<b>-0.8</b>

Source: World Bank and IMF staff

22. **As a result of the floods, significant public sector and external financing gaps opened up, which are expected to be financed by additional support from international partners.** On July 16, 2014, a joint Donors' conference (BH and Serbia) in Brussels received pledges for recovery and reconstruction in BH in the amount of Euro 809 million which would be sufficient to meet the new external financing gap (Table 4).

23. **Despite the uncertainties surrounding some implementation details of the reconstruction program, the macroeconomic framework is considered adequate.** Conditional on the pledged donor support (bilateral, EC and IFIs) and successful reconstruction efforts, public sector debt is considered sustainable over the medium term. The IMF's 6<sup>th</sup> and 7<sup>th</sup> SBA reviews (concluded on June 30, 2014) reached similar conclusions and the reforms supported by this DPL will contribute further to boosting sustainable economic growth over the medium term. In parallel, improving revenue

collection, and increasing some ‘sin taxes’ will help to reduce what will be a difficult fiscal stance due to reconstruction costs and keep public debt at sustainable levels. Economic growth (and hence any variables provided as a share of GDP) are sensitive to the speed of recovery from the floods. With a fast recovery, growth is expected to be driven by reconstruction efforts, notably in the construction sector (including housing and transport – both of which were badly hit) and upstream supply sectors including wholesale and retail. The reconstruction efforts will rely in part on imported materials, impacting the current account deficit (Table 5), which will also need to be supported through donor resources. Therefore, the medium term outlook presented in Table 1 rests on a rapid recovery from the floods, including timely disbursement and efficient spending of donor resources made available for reconstruction.

Table 4: External Financing Requirement, 2014-17 (% GDP)

	2014	2015	2016	2017
<b>Financial requirements</b>	<b>14.4</b>	<b>11.5</b>	<b>10.1</b>	<b>10.3</b>
Current account deficit	10.7	8.6	6.9	6.2
Amortization	3.7	2.9	3.2	4.1
Government	2.6	2.0	2.4	3.4
Other	1.1	0.9	0.8	0.6
<b>Financing</b>	<b>10.9</b>	<b>11.1</b>	<b>10.1</b>	<b>10.3</b>
Capital transfers	1.4	1.4	1.3	1.3
FDI	1.9	2.3	2.3	2.3
Net bank financing	-0.3	0.6	0.7	0.7
Foreign loans	6.6	5.6	4.7	5.1
Government	5.1	3.8	2.4	2.2
o/w post flood	2.0	1.3	0.0	0.0
Other	1.5	1.8	2.3	2.9
Gross International reserve	-0.1	-0.1	-0.1	-0.2
Other	1.4	1.4	1.2	1.0
<b>Financing gap</b>	<b>3.5</b>	<b>0.4</b>	<b>0.0</b>	<b>0.0</b>
IMF	2.7	0.1	0.0	0.0
EU	0.0	0.0	0.0	0.0
World Bank	0.8	0.2	0.0	0.0

Source: IMF

24. **With sufficient donor support, external debt is expected to stay contained over the medium term.** In 2013, BH’s external debt consisted of public external debt (28 percent of GDP) and estimated private external debt (25 percent of GDP, Figure 1). There are no comprehensive statistics on the private external debt in BH. The largest share (60 percent) of this debt is owed by foreign-owned banks, resulting mainly from subsidiaries’ borrowing from their parent banks to finance operations in BH. The remaining share of private external debt is owed by a number of large industrial companies (steel and aluminum manufacturers, large international retail chains) that are able to borrow directly from commercial banks abroad. In the medium term, external debt is expected to stay on sustainable path.
25. **On the domestic side, BH has limited formal public debt as bonds were not issued until 2007.** Bonds were issued to address the substantial domestic claims accumulated as a result of the 1992-95 war and the fiscal pressures in its wake. In response to a surge of court filings by individual claimants and vastly different court awards for similar claims, both entities

enacted laws in 2004 specifying the type and size of valid claims. With minor exceptions, the laws divided the claims into two large groups: liabilities for frozen currency deposits and liabilities for war damages. Repayment of these bonds has already begun. However, claims continue to be considered by the courts and the timeframe for verification of frozen foreign currency accounts may be extended. Given the limited development of local financial markets, governments in BH have not turned to them for regular issuance of bonds<sup>5</sup>.

Table 5: Balance of Payments, 2011-17 (% GDP)

	2011	2012	2013	2014	2015	2016	2017
			Est.		Proj.		
<b>Current account balance</b>	<b>-9.7</b>	<b>-9.3</b>	<b>-5.4</b>	<b>-10.7</b>	<b>-8.6</b>	<b>-6.9</b>	<b>-6.2</b>
Trade balance	-24.2	-24.3	-21.0	-26.2	-22.7	-21.3	-20.5
Goods balance	-32.4	-32.8	-29.6	-35.1	-31.6	-30.1	-29.0
Service balance	8.2	8.5	8.5	8.9	9.0	8.8	8.5
Net primary income	0.8	0.9	1.9	1.2	1.1	1.4	1.5
Net secondary income	13.6	14.2	13.6	14.2	12.9	13.0	12.8
<b>Capital and Financial Accounts</b>	<b>-9.2</b>	<b>-8.6</b>	<b>-7.1</b>	<b>-7.3</b>	<b>-8.4</b>	<b>-7.0</b>	<b>-6.4</b>
Capital account	1.4	1.3	1.3	1.4	1.4	1.3	1.3
Financial account	-7.8	-7.3	-5.8	-5.9	-7.0	-5.7	-5.1
<b>Net Errors and omissions</b>	<b>0.4</b>	<b>0.9</b>	<b>1.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>
Overall balance	<b>0.1</b>	<b>-0.3</b>	<b>-2.7</b>	<b>3.4</b>	<b>0.3</b>	<b>-0.1</b>	<b>-0.2</b>
<b>Financing</b>	<b>-0.1</b>	<b>0.3</b>	<b>2.7</b>	<b>-3.4</b>	<b>-0.3</b>	<b>0.1</b>	<b>0.2</b>
Change in net int'l reserves	-0.1	0.3	2.7	0.1	0.1	0.1	0.2
External financing gap (budgets)				3.5	0.4		

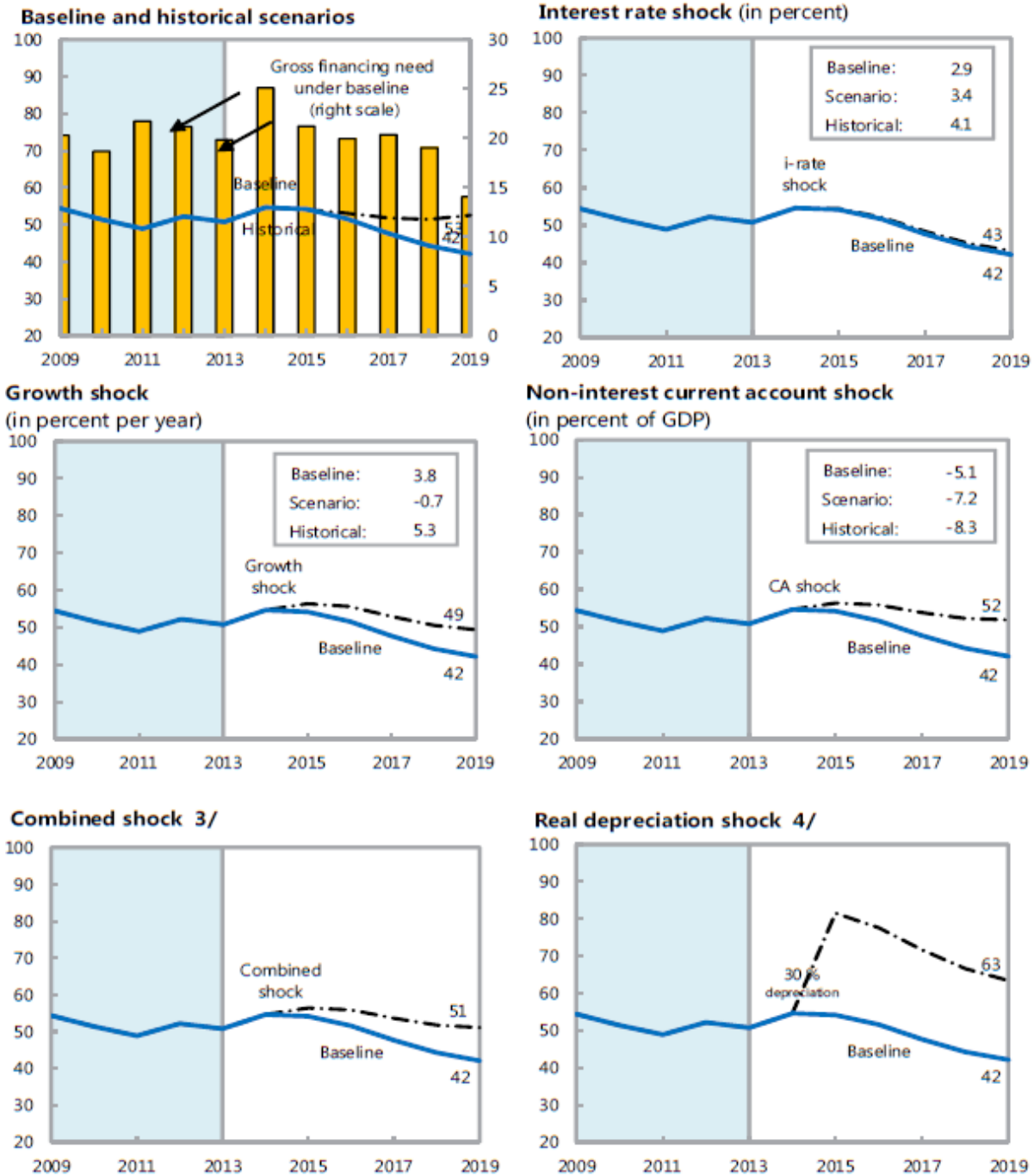
Source: IMF

**26. Public sector debt is expected to grow in 2014, but is sustainable in the medium term.**

According to a recent debt sustainability analysis, external public sector debt is expected to grow from 28.1 percent of GDP in 2013 to 32.9 percent in 2014 and 33 in 2015, while total public debt is projected to increase from 42.5 percent in 2013 to 46.2 in 2014. External financing requirements are projected to decline slightly over the medium term, from 9 percent of GDP in 2013 to 8.4 percent by 2018. This scenario is embedded in the overall macroeconomic framework, which assumes containment of public expenditure over the medium term. The scenario would be vulnerable to sharp currency depreciation, a non-interest CAD shock, an unexpected slowdown in GDP growth or inadequate fiscal consolidation. In particular, a depreciation of 30 percent would imply an increase in the debt level to around 63 percent of GDP in 2019 but have a large sudden increase to over 80 percent in the short term.

<sup>5</sup> The very first issuance occurred in May of 2011 by the RS government for Euro 15 million of 6-month treasury bills. In the first quarter of 2013 two successful auctions of entity T-bills were recorded, the first on SASE (Sarajevo Stock Exchange) with an average 1.89 percent interest rate which is the record low interest rate, and the second on BLSE (Banja Luka Stock Exchange) in RS with a record high average interest rate on 6M T-bills.

Figure 1: BH External Debt Sustainability Bound Test (External debt in percent of GDP)



Source: IMF, Country desk data, and staff estimates.

1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.

2/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.

3/ Permanent ¼ standard deviation shocks applied to real interest rate, growth rate, and current account balance.

4/ One-time real depreciation of 30 percent occurs in 2014.



## 2.3 IMF RELATIONS

27. **The World Bank and the IMF have been closely coordinating to help BH navigate external shocks, the recent floods and address key economic challenges.** Areas addressed include: entitlement reforms, labor market reforms, and measures to improve the business environment. This includes the recent review of the Fund’s SBA, which the authorities would like to extend into 2015. The 6<sup>th</sup> and 7<sup>th</sup> reviews of the SBA have been concluded successfully and were approved by the IMF’s Board on June 30, 2014. The IMF Board also approved an augmentation of the SBA by about Euro 95.7 million to meet the urgent needs caused by the severe floods of May 2014. BH’s macroeconomic fundamentals remain broadly sound while advances in the business environment are critical for achieving a more healthy economic position in the medium-term.

## 3. THE GOVERNMENT’S PROGRAM

28. **BH’s development strategy is guided by the EU accession process and supported at the state and entity level.** The entities enacted a number of strategy documents which define the country’s medium-term policy direction, including the BH Draft Strategy for Development and Social Inclusion, FBH Government’s Work Plan 2011–2014, RS Strategic Plan for Investment Climate Improvement, and Economic Policy Document 2013. The RS Strategic Plan and FBH government statements throughout 2013 outlined the need and roadmap for reforming the business environment. At the national and entity level, the overarching need for fiscal discipline is enforced by the SBA with the IMF. The SBA conditionality structure provides a firm framework designed to curb spending, foster reforms of the organic budget laws, and strengthen the business environment and the financial sector.

29. **Strengthening the business climate is a key area for BH’s economic prospects and since 2013 both entities have demonstrated their commitment to substantial reform, albeit at a different pace.** The authorities recognize that a strong private sector is important to facilitate job creation, enhance competitiveness and boost economic performance. The business environment in BH is the least friendly in South-East Europe and the country’s DB ranking remains low (Table 6). The costs and risks of doing business are high mainly because companies need to navigate excessive red tape which is compounded by overlapping competencies and lack of harmonization among laws. Since 2013, the entity governments have started to implement long-awaited reforms in order to increase trading, especially with the EU, and attract higher levels of FDI.

Table 6: Selected Doing Business Indicators for BH

Country	Year	DB Rank	Starting a Business	Dealing with Construction Permits	Trading Across Borders
Bosnia and Herzegovina	2013	130	164	172	109
	2014	131	174	175	107

Source: *Doing Business 2014*, World Bank

30. **The timing of government reforms is equally crucial.** The next general election for BH is scheduled for mid-October 2014. Economic recovery and political pressures for reducing bottlenecks to productivity, stimulating business’ creation and improving prospects for trading with the EU and neighboring countries are strong and well founded, despite the brief

but strong outburst of social unrest at the beginning of 2014. The unrest, although unsettling in its initial violence that was quickly curbed, prompted further action by FBH and cantonal level governments in recognizing and prioritizing the economic growth and anti-corruption agendas. The progress achieved so far demonstrate government ownership of the reform process and provides a sound basis for this operation.

31. **The broader reform program is likely to continue to benefit from the complementary Bank Group TA and the partnership with the IMF.** The Bank and the IFC will continue to provide technical assistance to both entities to support the implementation and follow-up after the enactment of laws and regulations supported by the DPL. This proposed DPL program for the Business Environment will deepen the partnership with the IMF and support complementary aspects of the BH economic reform program.

## 4. THE PROPOSED OPERATION

### 4.1 LINK TO GOVERNMENT PROGRAM

32. **This operation builds on the development strategies of the two entities and supports the competitiveness pillar of the World Bank Group Country Partnership Strategy (CPS).** The DPL focuses on the critical reforms that would improve the country's business environment, strengthen competitiveness of its key export sectors, and promote sustainable economic growth. This DPL is structured around three pillars and a development objective to improve BH's business environment through facilitating business start-up, streamlining procedures for inspections and construction, and simplifying cross-border trading processes. These core policies intend to improve BH's competitiveness, promote economic growth, and help facilitate the country's dialogue on the EU accession.
33. **The DPL is supporting many of the critical laws and regulations that would enhance BH's business environment.** The entity governments have adopted a number of regulatory reform packages which adds up to the most significant effort to reform the business environment for more than a decade. These reform packages include the new Law on physical space and construction (RS), the Inspections Law, and Company Law (FBH). In additional, governments have amended laws and secondary regulations to make it easier to register businesses and to simplify licensing, permits and approvals related to import/export procedures for selected sectors.
34. **Cooperation between governments in BH is a prerequisite for reform success.** Although the proposed reforms are discretionary to individual entities, they are intended to help businesses operate more effectively throughout BH. There has been increased collaboration in aligning the scope of proposed reforms between the two entities which is resulting in a more uniform business environment across the country.
35. **This DPL supports poverty reduction by stimulating faster growth and job creation.** With the level of unemployment rate at 27.5 percent (still above 2008 levels, LFS 2013), and particularly high among those without tertiary education (20 percent for those with primary

or less, 66 percent for those with only secondary), women (29 percent) and young people (59 percent among 15-24 year olds), removing barriers to job creation is a priority to increase job opportunities for those who do not have a foothold in the job market (Box 1).

Box 1: Ending poverty and achieving shared prosperity – Addressing the WBG Goals<sup>6</sup>

Improving BH's business environment will contribute to reducing poverty and achieving shared prosperity by increasing competitiveness of the economy, creating the foundations for job creation, opening up more opportunities for the poor and less well-off to improve their living standards and contribute to economic growth and ensuring higher and sustainable economic growth. Although official poverty statistics are not yet available post 2007, preliminary estimates suggest that the post-crisis contraction has halted the pre-crisis decline in poverty.

**Goal 1 – Ending extreme poverty.** In BH, poverty methodologies used both by the national statistical agencies and by the World Bank rely on poverty lines which are higher than the global \$1.25 per day threshold. According to this national poverty line, an estimated 14 percent of the population in BH lived in poverty in 2007 (2007 HBS). While more recent official poverty estimates are not yet available, there is an expectation that poverty has stagnated between 2007 and 2011, and then slightly increased in the aftermath of the floods. In order to eliminate poverty by 2030, poverty levels would need to decline by almost one percent per year, which corresponds to an annual growth rate of 2.8 percent until 2030 (assuming inequality remains unchanged). This would require a significant increase in growth from recent years where growth was on average below 1 percent. The measures supported by this operation aim at improving business environment by simplifying firms registration and operation, streamlining inspection procedures, improving sanitary standards in agriculture (one of the key areas of potential exports), and facilitating trade across borders.

**Goal 2 – Achieving shared prosperity.** This operation aims at improving the economic conditions for all citizens in the country. BH's poor, near-poor and lower middle class – *the bottom 40 percent* – are more likely to be unemployed and affected by high costs of living (HBS 2007). In addition, evidence from 2004 and 2007 shows that the bottom 40 percent grew only marginally faster than the rest of the distribution. Youth unemployment is particularly high and poses a threat to social and economic stability. The proposed reforms will address a priority of making it easier to start a business and rationalizing regulations, creating more opportunities for business, especially young firms. Analysis from the recent ECA Jobs Report shows that these successful young firms (or "Gazelles") accounted for 71 percent of BH's job creation in the past.

Source: BH Household Budget Survey (HBS), 2007; *Back to Work: Growing with Jobs in Europe and Central Asia*, World Bank, 2014

36. **This DPL pays particular attention to lessons learned from the First Programmatic Public Expenditure Development Policy Loan and the Business Environment Adjustment Credit (BAC).** Issues such as governments' absorption capacity and willingness to undertake non-controversial reforms (with immediate impact on business) within one year of the next election cycle were carefully considered during DPL design. This operation is building on a sub-set of the initially proposed reform program, the whole of which remains critical to enhancing the medium-term economic prospects of the country. Business environment reforms are realistic because there is consensus and concrete action across both entities to enhance the institutional environment for business, despite stagnation

<sup>6</sup> Data restrictions currently prevent the estimation of a shared prosperity indicator for BH. Due to restrictions in data access, robust poverty estimates are only available up to 2007. However, a recently signed Memorandum of Understanding (MoU) with the statistics offices is paving the way to providing more updated poverty and shared prosperity numbers and analyses.

in many areas of the broader economic reform program. This operation provides a framework for analysis and discussion focused on the medium-term reform effort in BH. Maintaining the dialogue while aligning priorities to those of EU accession and progress remains an important policy tool for the World Bank Group. The political risks remain significant, in particular in the FBH – the continued discord between government and parliament extends beyond any economic reform issues and may stall the relevant legislative processes.

#### **4.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS**

37. **This DPL supports key reforms to improve BH’s business environment.** It is designed around three pillars: 1) Facilitating Business Start-up, 2) Streamlining Investment Procedures in Inspections and Construction; and 3) Simplifying Processes of Cross-Border Trading. All these reforms will help BH to become more competitive.
38. **The Government’s own recent analytical work related to enabling business environment provides the foundation for this operation.** The authorities have undertaken a number of regulatory impact assessments of the business registration process, the company law and competitiveness studies of value chains in selected sectors over the last two years. These analyses, together with Bank’s own Economic Sector Work (ESW) since 2009, including the Compliance Cost Savings (CCS) analysis, provide the analytical underpinning for this project. Additionally, the operation relied on the analyses and findings of other analytical work, not directly linked to the three pillars but having a significant impact on the overall fiscal, economic and social policy environment in BH<sup>7</sup> (Table 7).
39. **The CPS Progress Report of June 2014 confirms the strategic focus on competitiveness for the remainder of the CPS period.** Amidst the fragile economic recovery, the recent devastating floods and the burden of the recovery effort governments face, focus on improving the business environment and thus competitiveness by supporting governments with this operation provides a platform for creating opportunities for job creation, vibrant private sector and economic growth.

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<sup>7</sup> “Are skills constraining growth?” 2009, “Public Expenditure and Institutional Review” 2012, “Labour Force Survey” 2013, “Public Expenditure and Financial Accountability” 2014.

Table 7: DPL Prior Actions and Analytical Underpinnings and Status of Reforms

Prior actions	Analytical Underpinnings	Status of Reforms
<b>Operation Pillar 1: Facilitating Business Startup</b>		
Prior action #1 - <i>Enactment of the Business Registration Reform legislative package and adoption of notary fees regulation in RS</i>	Government analytical work: Regulatory Impact Assessment Report on Business Registration process in RS; Bank ESW: Doing Business Report 2012, 2013, 2014; Other analytical work: EC Progress Report;	<b>Completed;</b> RS Parliament adopted the full package end-July 2013 <b>Completed;</b> RS Government adopted decree on notary fees July 18, 2013
Prior action #2 – <i>Government adoption and submission to Parliament of the final draft of the Company Law in FBH</i>	Government analytical work: Regulatory Impact Assessment Report on FBH Company Law; Bank ESW: Doing Business Report 2012, 2013, 2014; Other analytical work – EC Progress Report;	<b>Completed;</b> Government adopted the final draft of the Law and submitted to Parliament for second and final reading on July 10, 2014 and House of Representatives has approved it on July 24, 2014. <i>N.B. Final parliament approval by House of Peoples is expected end September 2014</i>
Prior action #3 - <i>Enactment of Law on Changes and Amendments to the Business Registration Law and adoption of regulation to reduce notary tariffs in FBH</i>	Government analytical work: Regulatory Impact Assessment Report on FBH Company Law; Bank ESW: Doing Business Report 2012, 2013, 2014; Other analytical work: EC Progress Report;	<b>Completed;</b> FBH Parliament adopted the Law on Changes and Amendments to the Business registration Law on June 30, 2014, effective on August 14, 2014. <b>Completed;</b> FBH Ministry of Justice adopted changes to Notary Tariff decision, effective August 1, 2013.
<b>Operation Pillar 2: Streamlining Investment Procedures in Inspections and Construction</b>		
Prior action #4 - <i>Enactment of the new Inspection Law in FBH</i>	Other analytical work: Firm-level data collection and analysis of the crisis effect. EU final report of food and veterinary audit carried out in BH, May 2012	<b>Completed;</b> FBH Parliament adopted the Inspections law on June 30, 2014, effective on September 11, 2014.
Prior action #5 - <i>Enactment of the Spatial Development and Construction Law and adoption of three accompanying rulebooks in RS</i>	Bank core ESW: CCS Analysis in 2012. <sup>8</sup> Bank ESW: Doing Business Report 2012, 2013, 2014.	<b>Completed;</b> RS Parliament adopted Construction Law, April 25, 2013. Three rulebooks adopted on Dec 31, 2013.
<b>Operation Pillar 3: Simplifying Processes of cross-border trading</b>		
Prior action #6 - <i>Adoption of regulations (rulebooks) to streamline export/import procedures in FBH</i>	Government analytical work: Competitiveness Study for three value chains in the agribusiness sector; Bank core ESW: CCS Analysis in 2012.	<b>Completed;</b> FBH Government adopted decree on reducing fees charged for inspection quality control at borders enabling streamlining of 5 export-import permits and procedures. FBH Ministry of Agriculture adopted Rulebook(s) enabling streamlining of 58 export-import permits and procedures in April 2013.
Prior action #7 - <i>Adoption of regulations (rulebooks) to streamline export/import procedures in RS</i>	Government analytical work: Competitiveness Study for three value chains in the agribusiness sector; Bank core ESW – CCS Analysis in 2012.	<b>Completed;</b> RS Ministry of Agriculture adopted Rulebook(s) enabling streamlining of 50 agribusiness related export-import permits and procedures in July 2013.

<sup>8</sup> Baseline and costs are defined in order to calculate the impact indicator by applying the CCS methodology of the Investment Climate Practice of the World Bank Group. This methodology calculates the extra resources that private businesses may use to expand their businesses or make new investments.

## **Pillar 1: Facilitating Business Startup**

### *Prior action 1: Enactment of the Business Registration Reform legislative package and adoption of notary fees regulation in RS*

40. **RS established a One-Stop-Shop (OSS) for business registration.** A detailed analysis of the previous processes revealed that to register a business in RS would take 23 days, 10 or 11 procedures and between 1,100 BAM to 1,500 BAM in registration cost. In order to complete the OSS reform, some 25 different laws, regulations, decrees, would have to be amended and an IT system procured and installed. Based on this analysis, the authorities have initiated a two-phased approach. Phase 1, the subject of this operation, involves legislative reform to cut the cost and time of starting a business by 50 percent, and enable initiation of Phase 2. The reform involves changing a package of 13 different laws and regulations, most notably the Company Law (reducing founding capital requirement from BAM 2,000 to BAM 1); changing Law on Court Taxes and Fees (court registration costs eliminated for the first business registration) and Law on Administrative Taxes (maximum fee for registering crafts set at BAM 30), and changing Regulation on Notary Fees (for simple company registration notary fees reduced). This work has been completed, and RS enacted the regulatory changes.

### *Prior action 2: Government adoption and submission to Parliament of the final draft of the new Company Law in FBH*

41. **In FBH, the Company Law is a critical element of reducing the administrative burden in starting and conducting a business.** The current Company Law creates additional costs and procedures to the business registration process. It was originally approved in 1999, and since then has undergone 13 changes. The existing version of the Law are outdated and in contradiction with some procedural laws adopted subsequently. The new Company Law foresees introduction of modern corporate management practices (defining competences and relations between corporate structures), streamlined and improved registration policies (reducing founding capital requirement from BAM 2,000 to BAM 1,000 and cutting business registration time and cost for businesses) and associate enterprises practices (defining type and options for associated enterprises, including economic interest group); generally aligning some aspects of the new Law with relevant EU directives<sup>9</sup>. The final draft Law was adopted by the FBH Government on July 14, 2014, following completion of the 30 days long public consultation process. The House of Representatives subsequently adopted the law on July 24, 2014 and it has now reached the final parliamentary stage at the House of Peoples where it is scheduled for final adoption in September 2014.

### *Prior action 3: Enactment of Law on Changes and Amendments to the Business Registration Law and adoption of regulation to reduce notary tariffs in FBH*

42. **FBH prepared amendments to the Business Registration Law to enhance the registration process and reduce registration costs by 50 percent.** The proposed changes are aimed to reflect and support parallel changes to the Company Law and to further

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<sup>9</sup> Directive 2007/36/EC on shareholders rights, Directives 89/666/EEZ, 2005/56/EZ, 2012/17/EU on Business registries, Directive 2006/46/EC on responsibilities of board members on financial reporting, Directive 2009/102/EC on limited liability companies.

streamline and improve the business registration process, aligning it with other relevant laws in FBH, such as taxation and statistics laws. This existing Law was originally adopted in 2004, and was changed twice in the past eight years. However, it is outdated and does not align with other laws that were adopted in recent years, which creates a bottleneck for ease of entry in FBH. Changes are focused on eliminating some unnecessary documentation and some duplicative procedures with the tax authorities, and reducing processing time.

43. **The entity governments have indicated that they intend to continue streamlining business registration in their jurisdictions.** As a next step in the reform effort, the entities will likely embark on developing a modern legislative framework for corporate insolvency and restructuring, including harmonizing tax laws in both entities, as well as introducing of out-of-court restructuring for businesses and streamlining the regulatory framework for contract enforcement. This process is supported by the EU through the Public Administration Reform Coordinator's Office of BH.

## **Pillar 2: Streamlining Investment Procedures in Inspections and Construction**

### *Prior action 4: Enactment of the new Inspection Law in FBH*

44. **Inspection reform is a systemic public sector reform that has significant impact on private sector development.** Reforming the inspections system and ensuring vertical coordination in official controls is a critical element in the overall system of conditions BH must meet in order to be able to export to the EU. According to an EU report on the food and veterinary system (May 2012), vertical coordination and official controls in BH are not aligned with those of the EU. Dairy, meat, and fruit and vegetable products cannot be exported to the EU countries. Adoption of a new Inspection Law is the only viable solution for vertical coordination of official controls between the State, FBH and cantons, and is the key structural reform to be supported in the FBH under this pillar.

### *Prior action 5: Enactment of the Spatial Development and Construction Law and adoption of 3 accompanying rulebooks in RS*

45. **Reforming the construction permit process in RS has been a key structural reform undertaken in 2013.** Insufficient permit-related legislation due to lack of transparency and consistency is a challenge for SMEs with limited connections. The World Bank Enterprise Survey Index, which provides a measure of the challenges end users face from exposure to different bureaucracies, revealed that companies face more issues related to corruption in countries with difficult construction permit processes compared to those with transparent processes. The Doing Business 2014 report ranks BH at 175th place (out of 189 economies) on obtaining construction permits, with 17 procedures, 170 days, and at a cost of 1,100 percent of income per capita.
46. **The new Construction Law introduces a risk-based approach and streamlined and cost efficient procedures.** The Law provides for faster and more efficient administrative processing of infrastructure projects. For instance, under the new provisions, for buildings of up to 400 m<sup>2</sup> the requirement to obtain a site/urban permit is abolished when a spatial/zoning plan has been adopted in the locality. The process and documentation for issuing construction and usage permits have been streamlined, and businesses should get both in 15 days,

respectively (if all documentation is complete), irrespective of building size. This enables up to BAM 17 million savings for businesses annually. The MoSP prepared and adopted a set of four key implementing regulations to close the implementation gap: *The Rulebook on Format, Content and Manner of Development of Site Conditions/Requirements*, *The Rulebook on Content and Control of Technical Documentation*, *The Rulebook on General Rules of Urban Planning and Parceling*, and *The Rulebook regulating structure, elements and manner of defining urban construction land*. All the regulatory and legislative work had been completed by December 31, 2013.

### **Pillar 3: Simplifying processes of cross-border trading**

47. **Reducing the administrative burden and simplifying export/import procedures will strengthen BH's capacity as an open economy.** The EU (including Croatia) is BH's largest trading partner with 74 percent of total exports and 61 percent of total imports. Export/import procedures are imposed by different authorities creating a complex mix of demands for businesses. Although conducting the same procedures, authorities at different levels require different documents and define different processes for businesses to follow. As a result, these procedures have been branded as complex because of the complicated regulation, compound risk management due to steps that although foreseen are not legally required, and burdensome and costly approvals.
48. **Businesses spend around US\$135 million annually to comply with complex export/import procedures.** Wood processing, machinery, electronic appliances, metal processing, dairy, meat and meat processing, and fruits and vegetables are BH's key export sectors. Exports for these seven sectors require more than 240 procedures to be conducted within 22 institutions at the national, entities' and cantonal levels. Reforming 154 procedures in FBH and RS should enhance export and result in cost and time reduction, with associated cost reductions of up to BAM 2 million from the identified baseline of BAM 50 million<sup>10</sup>.

#### Prior action 6: Adoption of rulebooks to streamline export/import procedures in FBH

49. **The FBH government's strategic objective to strengthen capacities for export/import requires comprehensive streamlining and procedure reforms.** Changes to respective secondary legislation have been initiated, with the aim of efficiently achieving cost savings and reduce processing times (indirect costs). Over the past three months, FBH authorities have adopted rulebooks on streamlining procedures related to exports in agricultural products, as well as a rule book defining the costs of quality control of goods in exports and imports. These efforts have resulted in estimated cost savings of about BAM 1 million.

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<sup>10</sup> Baseline and costs are defined in order to calculate the impact indicator by applying the Compliance Cost Savings (CCS) methodology of the Investment Climate Department of the World Bank Group. This methodology is not a comprehensive cost-benefit analysis. It is a one-sided view of the reforms' benefits to the private sector and it provides an indication of the resulting extra resources that private businesses may use, at least in part, to expand their businesses or make new investments. The baseline and calculated savings are based on official 2012 data (frequencies, time, fees, taxes, average labor costs, number of operating businesses and other support statistics data) and verified by CCS specialists.



*Prior action 7: Adoption of regulations (rulebooks) to streamline export/import procedures in RS*

50. **RS Government's strategic objective to strengthen capacities for export/import requires comprehensive streamlining and procedure reforms.** With the recent adoption of the Amendments to the Law on Administrative Fees and Instructions on the Method of Operations and Conduct in Certain Administrative Proceedings, to streamline procedures related to importing inputs and exports in agricultural products, RS saw savings of almost BAM 920,000 in these areas.
51. **In the future, BH will still have great need to further simplify trading across borders.** In a next phase of reforms, the entities are likely to support the implementation of the risk-based border inspection clearances to facilitate trade and increase competitiveness of the selected sectors by streamlining customs procedures and regulations in line with EU requirements.

#### **4.3 LINK TO CAS AND OTHER BANK OPERATIONS**

52. **The proposed DPL is consistent with the Country Partnership Strategy (CPS) for FY12-15.** This Business Environment DPL will support the CPS pillar of competitiveness. Its objective is to support economic growth by addressing the bottlenecks hindering competitiveness and increased productivity growth. By supporting improvements of the business environment and investment climate, the operation will also support creation of pre-conditions for post-crisis growth. The recent progress report of the CPS noted that the joint IBRD/IFC Business Plan, focusing on this pillar, was effective in enhancing competitiveness and that it contributed to job creation. This DPL builds on the analytical underpinning and the technical advice provided against the backdrop of the competitiveness portfolio.
53. **The WB and IFC in BH continue to coordinate future interventions, enhance collaboration, and leverage complementarities between lending and technical assistance.** This operation, with its focus on policies that affect companies' operations, through improving the cost of doing business and the way government administration operates, touches on an area of shared interest, joint intervention and client demand in BH. A number of its interventions were identified through a coordinated approach to client activities within the existing CPS. Possible future interventions will benefit from complementarity of delivery, cross support and joint teams.
54. **This DPL builds on and is supported by Technical Assistance of the World Bank Group.** The IFC has a number of active projects which have provided a framework for this operation. These activities enhance BH's export competitiveness to streamline import/export procedures, and assist drafting and enactment of the modern Construction Law in the RS by providing TA to narrow the implementation gap at the local level and to assist with preparation of the improved Company Law in the FBH. The World Bank for its part is engaged in SME financing, a critical area to stabilize the economy, particularly during the economic slowdown since 2009. This DPL also builds on a World Bank trust fund that assists the entities in modernizing legislation and reforming inspections operations to bring both into line with EU standards, and reduce the burden on companies by introducing risk-based inspections.

#### 4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

55. **All legislative measures and reforms are subject to a consultation process within and outside of governments in BH.** This includes a consultative mechanism with the groups that are likely to be affected, adversely or not, by these laws. The process is embedded in BH's institutional setup and represents an integral part of the legislative process.
56. **The consultative mechanism consists of multiple filters to ensure valid checks and balances.** The processes include: i) Drafts of new laws and those to be amended are usually prepared as a joint effort of an inter-institutional working group consisting of officials from different ministries or agencies; ii) prior to regular government approval and parliamentary procedure, these drafts are subject to review and comment from the economic and social councils, as well as to clearance by the respective ministries of justice and finance and the legislative offices;<sup>11</sup> iii) since 2012, all draft legislation has to contain tables of concordance rationalizing compliance with respective EU legislation and commitments set in the Stabilization and Association Agreement; iv) once in parliamentary procedures, drafts are reviewed and discussed in a broader forum involving various interested parties;<sup>12</sup> and v) prior to final discussion and adoption within the parliament, respective parliamentary committees review and provide feedback on proposed drafts, and ensure that all procedures were conducted appropriately, all relevant comments were addressed, and the entire supporting documentation is provided.
57. **The World Bank collaborated closely with the IMF and Delegation of the European Commission (EUD) to ensure parallel discussions and coordination with USAID, Swiss SECO, and Swedish Sida in the preparation of this program.** The Bank and the IMF consulted over the macroeconomic, structural and private sector development reforms, as the IMF Stand-By structural conditionality included a number of benchmarks directly related to the business environment. These discussions concentrated on how the proposed reform package will impact ongoing and planned activities in the business environment, primarily the OSS for business registration and the new inspections systems. Despite the political standstill of the EU accession agenda, which is hampered by the lack of agreement on implementation of the Sejdic-Finci ruling and absence of the BH coordination mechanism for the Instrument for Pre-Accession (IPA), the EU is supportive of the DPL reforms as they align relevant legislation and practices to those of the EU, and help maintain momentum until high-level issues are resolved. The EU is considering a new approach for BH recognizing that it is needed if BH is to speed up the economic (and social) reforms and progress towards the EU, in particular as consensus among BH politicians has yet to be achieved. It is envisaged that the EU's planned work in BH will benefit from implementation of the DPL reforms, in particular the inspections and the business registration reforms.

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<sup>11</sup> The latter confirms constitutional and fiscal compliance of the proposed draft.

<sup>12</sup> Such as chambers of commerce, industry associations, unions, local authorities' representatives, NGOs, and think-tanks.

## 5. OPERATIONAL AND IMPLEMENTATION ISSUES

### 5.1 POVERTY AND SOCIAL IMPACT

58. **The global crisis and the slow recovery eroded some of the earlier progress in poverty reduction.** The latest official absolute poverty figures for BH predate the crisis and show robust poverty reduction until 2007, when the last available HBS was collected. Absolute poverty had declined from 18 percent in 2004 to 14 percent in 2007.<sup>13</sup> The Life in Transition Survey of 2010 provides some early indicators of the pressures that households have been under in the last few years. For example, 64 percent of households reported they had been affected either “a great deal” or “a fair amount” by the crisis, with higher impacts reported in urban areas. As 77 percent of the poverty reduction experienced between 2004 and 2007 can be attributed to the impact of growth in mean consumption (rather than redistributive shifts), this suggests that the impact of the crisis and the slow recovery that followed might have resulted in an erosion of previous gains in poverty reduction. This appears to be validated by other more recent indicators. For example, the employment rate in 2013 has been estimated at 31.6, still below the 2008 (pre-crisis) level of 33.2, while the unemployment rate is at 27.5 percent, versus 23.4 in 2008 (all data from the Agency for Statistics of BH, or BHAS).
59. **The prior actions supported under Pillars 1 and 2 are unlikely to result in any negative distributional effects.** By improving the investment climate and simplifying business procedures, more jobs are likely to be generated by facilitating the establishment of new companies. Indeed, recent analysis of the Business Environment and Enterprise Performance Survey (BEEPS) (ECA Jobs Report, World Bank 2014) highlighted how in BH, as in the rest of the region, younger firms tend to create more jobs than the more established ones<sup>14</sup>. For the construction sector, for instance, if more infrastructure projects – and thus jobs – emerge as procedures become more efficient (Pillar 2), this is likely to have an impact on the well-being of lower wage earners; in 2007, the construction sector in RS occupied around 17 percent of working-age individuals in the first quintile (compared to 13 percent in the bottom 40 percent and 10 percent in the top 60 percent).
60. **The measures supported under Pillar 3 have the potential to lead to some complex distributional shifts by simplifying and reducing the number of procedures for licensing, obtaining permits and approvals related to import/export in selected sectors.** Those holding licenses and permits might experience a short term decline in profits due to increased competition. The losses should be weighed against the benefits of having new domestic entrants with the potential to lower prices including for staple foods. It is possible that these distributional effects will be small, and not negative.
61. **The policy measures supported by the DPL could have positive gender impacts, but data gaps limit full analysis.** In BH, 24 percent of formal firms have a female top manager,

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<sup>13</sup> Estimates based on the BAM 205 poverty line. Note that 2004-2007 dynamics are only available for the BAM 205 line, and not for the BAM 238 line. Shared prosperity figures for BH are currently not available as there are no relevant data-points from 2008 or later. The release of the latest official poverty figures and the data of the HBS 2011 are expected to provide useful information to that end.

<sup>14</sup> Although the gap between young and established firms is less pronounced in BH than in EU11 countries; a possibility is that established firms in BH face more disincentives to grow.

and 27 percent have female participation in ownership (BEEPS 2013). This suggests that many women entrepreneurs may face disproportionately higher barriers to establish a formal firm. The enterprise survey (BEEPS 2013) also shows, that female managers are more likely to report that licensing and permits are the biggest obstacle to their firms' operations (4.5 percent of women compared to 3.7 percent of men). In addition, recent qualitative work on labor markets and gender in BH shows that women are less likely to state that their communities are good places to start a business. Reducing barriers to entrepreneurship, including the reforms supported under this DPL, would thus promote equality of access and narrow the gender gap in access to economic opportunities.

## 5.2 ENVIRONMENTAL ASPECTS

62. **As required by the World Bank's OP 8.60, the team has carried out an assessment of the expected impact of this operation on the environment, on forests and natural resources and analyzed the broader context of environmental policy making in BH.** Specific country policies supported by the operation are not likely to have significant effects on the environment and natural resources in BH. The measures contemplated under the loan are primarily geared towards supporting the Government's reforms in enabling and enhancing the business investment climate, facilitating trade across borders, and improving the country's competitiveness. Currently, none of the sectors included in the operation are expected to have any direct significant links to the environment. There is potential for indirect positive environmental impacts through poverty alleviation that would lead to improvements in more sustainable use of natural resources and improved production technologies. The legislation in place and functioning at the Entity level will provide adequate identification, mitigation, monitoring and evaluation of environmental impacts.
63. **The environmental legislation in BH is enforced at the Entity levels and Brcko District and is predominantly aligned with the EU *acquis*, although enforcement and full implementation still need strengthening.** The key laws on topics as related to this Operation include Environmental Impact Assessment, Waste Management, Air Quality Protection and Protection of Nature, as well as international treaties. Environmental oversight in BH is delegated to the Ministry of Spatial Planning, Civil Engineering and Ecology of RS, Ministry of Environment and Tourism in FBH, and the relevant Cantonal ministries within the FBH. All laws have been in place since 2003 (2002 in RS), and the ministries are most experienced with environmental permit procedures. However, due to a number of requests and lack of staffing, some delays may be linked to issuing of full-EIA environmental permits.
64. **Laws on Construction and Physical Planning both in RS and FBH are harmonized with the relevant environmental protection measures in order to ensure adequate environmental management including protection of vulnerable natural areas.** According to the FBH Law on Physical Planning and Law on Environmental Protection, a Strategic Environmental Assessment (SEA) is mandatory for all strategic planning documentation including physical planning. In RS, there are no requirements for an SEA, but the overall procedure is more streamlined because one ministry governs physical planning and environmental protection. The Law on Physical Planning and Construction of RS (Construction Law) makes references to environmental protection, sound environmental practices, and protection of cultural heritage throughout the document and specific natural

areas under specific protection regimes for the purposes of physical planning. The Law references these areas as mandated by specific laws governing each of the thematic areas. Furthermore, a substantial section of the Construction Law promotes and ensures energy efficiency in new construction. Even though this Construction Law in RS does not include provisions for SEA in physical planning (which is beyond the scope of this Operation), it does simplify the procedure for obtaining a construction permit as based on location conditions and technical conditions for construction. Nonetheless, one of the requirements for a construction permit is an Environmental permit (based on an Environmental Impact Assessment) which should in all aspects target the possible negative environmental impacts of such construction and propose adequate mitigation measures which are legally binding and aim at mitigating and avoiding all environmental impacts associated with that specific construction.

### **5.3 PUBLIC FINANCIAL MANAGEMENT, DISBURSEMENT AND AUDITING**

#### **A. Fiduciary Aspects**

- 65. Public Financial Management (PFM) System.** The 2007 Fiduciary Update<sup>15</sup> on Public Financial Management found that the automated treasury system has been the key to improved budget execution and cash management in the State and the two Entities. This has improved controls, brought discipline to the budget execution system, and improved overall cash management across the State and Entities. BH has made good progress in establishing modern public financial management institutions and systems. Further progress is needed to ensure that budget discipline is uniform and consistent across the entire system of public resource management and to counter weak compliance with procurement law and internal controls, weak internal audit capacity, weak governance in state-owned enterprises (SOEs), and widespread corruption. The fiduciary risks associated with the PFM system in BH are moderate.
- 66. BH has made some progress in government budget transparency as measured by the 2012<sup>16</sup> Open Budget Index Assessment (OBI).** The OBI shows that the BH government discloses some information on the central government budget and financial activities during the course of the budget year. State and entity budgets are disclosed and publicly available upon adoption. The 2012 OBI for BH provides important recommendations on how to further improve budget transparency and oversight.<sup>17</sup>
- 67. Public procurement remains weak, despite a common Public Procurement Law (PPL) based on international best practices.** The law is applicable across the State and two Entities, but compliance has been weak. Progress has been made in establishing important institutions such as the Public Procurement Agency (PPA) and the Procurement Review Body (PRB). Under the IMF Stand By arrangement a new law on public procurement was adopted in May 2014.

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<sup>15</sup> In addition to the 2007 Fiduciary update, in the course of preparation several recent external reports have been consulted to review the actions taken to improve the public financial management system and to present the current reform status.

<sup>16</sup> BH's OBI 2012 score of 50 increased from its score of 44 on the OBI 2010.

<sup>17</sup> <http://internationalbudget.org/wp-content/uploads/OBI2012-BosniaHerzegovinaCS-English.pdf>

68. **The budget execution process has been steadily strengthened.** MoFT has introduced a Treasury Single Account (TSA). Although the system is in place, it needs to be further strengthened. Currently, there is no functioning cash management covering both the state level and entities. According to the Law on Financing the Institutions of BH, all budget-users may request the MoFT to open a supplementary account for the collection and use of donations as well as own revenues. According to the same Law, the MoFT is required to record budget revenues and expenditures by using the modified accrual basis of accounting, and to promulgate a rulebook on accounting and financial reporting, which is to include a chart of accounts and a budget classification framework in accordance with internationally recognized standards.
69. **A number of important improvements in public finance have been implemented in recent years, and some steps have also been taken to improve coordination.** The development with the most impact is the adoption of the Law on the Fiscal Council. Further challenges remain in terms of implementing the law. Some other results achieved relate to the steps taken to harmonize budget calendars.
70. **Supreme Audit Institutions are independent from the legislature and the executive.** The three Supreme Audit Institutions (SAIs) of BH have achieved good results in a complicated environment and with limited resources. Since 2000, the three SAIs have gradually improved their audit capacity and enhanced their audit coverage. They have played a key role in strengthening responsibility, transparency and efficiency of financial management in all of BH. All three SAIs have formally adopted the INTOSAI standards. Additional efforts will be required to increase responsiveness on Auditor's recommendations.
71. **Management of Foreign Exchange.** The IMF implemented a safeguards assessment<sup>18</sup> of the Central Bank of BH (CBBH) in October 2009, and conducted a safeguards mission in November 2012<sup>19</sup>. The assessment concluded that the CBBH continued to have a relatively strong safeguards framework and addressed all recommendations from the initial 2005 safeguards report. As a result, using the CBBH to channel the DPL funds to the BH Institutions, and then further to the entities, is assessed acceptable. The CBBH auditors Deloitte d.o.o. Sarajevo have issued an unmodified auditor's report for the year ended 31 December 2013.
72. **The overall financial management risk to Bank DPL funds is moderate.** Ample safeguards exist in the CBBH to record and track foreign currency funds received under the Bank's DPL program.

## B. Disbursement and Auditing

73. **Borrower and Loan Amount:** The Borrower is BH. This operation is a single-tranche loan. The loan proceeds would be made available to the Borrower upon the effectiveness of the Loan Agreement between the Bank and BH.

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<sup>18</sup> January 2005, Safeguard Assessment of the CBBH; October 2009 Safeguard Assessment of the CBBH.

<sup>19</sup> December 2012, BH: First Review Under the Stand-By Arrangement and Request for Waiver of Nonobservance of a Performance Criterion —Staff Report; Press Release; and Statement by the Executive Director.

74. **Disbursement:** Upon approval of the loan and notification by the Bank of the effectiveness of the Loan Agreement between the Bank and BH, the Borrower will submit a withdrawal application to the International Bank for Reconstruction and Development (IBRD) within a defined drawdown period. The IBRD will deposit the proceeds of the loan into a foreign currency deposit account designated by the Borrower to be held at the Central Bank of BH (CBBH). The Borrower shall ensure that upon the deposit of the Loan into said account, an equivalent amount is credited in local currency to the two sub-accounts, one for FBH and another for RS, also kept in CBBH and that is available to finance budgeted expenditures of the relevant Entities.
75. **Accounts, Auditing and Closing Date.** The administration and accounting of the loan will be the responsibility of the Ministry of Finance and Treasury of BH. The Ministry of Finance and Treasury will be responsible for the loan administration and for preparing the withdrawal application, and maintaining the withdrawal application as required. The Ministry of Finance and Treasury and the Entity MoF, with the assistance of CBBH, will maintain records of all transactions under the loan in accordance with sound accounting practices. Given the positive IMF assessment of CBBH, an audit of the deposit account for the proceeds of the loan is not considered necessary. The Ministry of Finance and Treasury will provide the Bank, within 30 days, a confirmation letter stating that the DPL funds have been received and deposited into the designated account assigned by the borrower that forms part of the Borrower's budget management system.

#### 5.4 MONITORING AND EVALUATION

76. **The World Bank will work in close cooperation with the Government of BH to monitor and assess the implementation of the proposed reform agenda.** The Ministry of Finance and Treasury of the BH will perform the overall monitoring and evaluation of the implementation of the suggested operation within its ongoing mandate and responsibilities. The RS and FBH Ministries of Finance will be responsible for implementation of the proposed operation and for coordinating actions among other concerned ministries and agencies in their jurisdictions. Other ministries involved include: (i) Ministry of Justice, Ministry of Energy, Mining and Industry, Ministry of Agriculture, Water Management and Forestry, and Ministry of Trade in the FBH; and (ii) Ministry of Justice, Ministry of Economic Relations and Regional Cooperation, Ministry of Agriculture, Forestry and Water Management, Ministry of Trade and Tourism, and Ministry of Spatial Planning, Civic Engineering and Ecology in the RS. All actors have the capacity and mandate to undertake monitoring against result indicators. The CCS methodology will help to measure the benefit of reforms and data for the specific set of reforms within this DPL is readily available. Relevant ministries noted above will collate and analyse as part of this operation and their ongoing mandates.
77. **The World Bank will monitor the implementation of the program and track the result indicators.** As part of the monitoring and evaluation process, the World Bank will track the baseline and result indicators provided in the policy and results matrix (Annex 1) based on the economic and legislative data provided by the government agencies and disclosed in the official sources. The World Bank team will conduct technical missions in the country to

maintain the dialogue with the authorities and to assess the compliance of the authorities with contractual provisions under the loan agreement.

## 6. SUMMARY OF RISKS AND MITIGATION

78. **The overall risk rating for this operation is substantial.** Complex governance structures, political tensions coupled with the unrests in February 2014, devastating floods in May 2014 requiring extensive recovery efforts, and a poor recent track record in implementing structural reforms pose a substantial risk to this operation. These risks are mitigated by the stand-alone nature of the DPL supporting already completed and politically non-controversial reforms and extensive TA activities. Furthermore, strong commitment and ownership of the reform agenda are coupled with close dialogue and ongoing technical assistance by the World Bank and IFC.
79. **Political and institutional risks remain significant.** BH's governance structures will remain complex, leading to slow and cumbersome decision-making. Reform of the business environment is seen as relatively uncontroversial, however, with buy-in across the two entities and various political parties. Mid-October elections are not likely to result in changed policy positions related to the business environment. At the same time, it is unlikely that the reform momentum will accelerate significantly after the elections, making it critical to maintain the focus on reform areas, such as the business environment, where forward progress remains possible.
80. **There are notable risks to the macroeconomic outlook.** The economic recovery is sensitive to the speed with which reconstruction happens. Failure to act quickly and disburse donor funds will slow growth further from the estimate of -0.7 percent. In addition, there are external risks related to the remaining weaknesses in the Euro-zone. Poor growth in the Euro-zone would have a negative effect on BH's economic outlook as it is expected to slow exports and reduce remittances since the EU countries continue to be BH's largest trading partners. External economic developments and the pace of economic recovery in the key export markets are both uncertain and beyond the control of the authorities. Despite the traditional strength of BH's financial sector, there are new vulnerabilities in particular the quality of credit portfolios as they continue to deteriorate. Although reliance on parent banks has declined, continued global financial market turbulence or a further downturn in Europe could make it more difficult for banks to raise funds from parent groups if required to deal with the NPLs. In the absence of an adequate regulatory framework to deal with NPLs, their disposal has proven difficult for banks. If macroeconomic risks materialize, the environment for continued reforms designed to improve the business climate would likely become more difficult to achieve as those with vested interests in preventing reforms would not have the "cushion" of higher economic growth. On the other hand, a poorer economic climate at home could increase the imperative to improve the business climate to make it easier for firms to export.
81. **Some of these risks are mitigated through a strong broad-based support for the reform program supported by the DPL.** Reforms supported by the DPL have been discussed extensively and agreed with the authorities. These reforms benefit from broad support at all levels of government and will help stimulate economic activity reducing downside



macroeconomic risks. The IMF SBA will help mitigate fiscal risks, which could arise in the event of slower-than-expected growth, or due to political reasons. The SBA also supports business environment reforms that complement the areas supported by the DPL.

82. **Environmental risk remains low while the overall financial management risk to Bank DPL funds is moderate.** BH has made sound progress in establishing appropriate public financial management institutions and systems. Important progress is needed to ensure that budget discipline is uniform and consistent across the entire system of public resource management in order to counter weak compliance with the procurement law and internal controls, weak internal audit capacity, and weak governance in SOEs.

Annex 1: POLICY AND RESULTS MATRIX

Prior Actions and Triggers		Result indicator: target
Prior Actions under DPO	Result indicator: baseline	
<i>Program Development Objective – To improve BH's business environment through facilitating business start-up, streamlining investment procedures in inspections and construction, and simplifying processes of cross-border trading</i>		
<i>Pillar 1 – Facilitating Business Start-up</i>		
Prior action #1 Enactment of the Business Registration Reform legislative package and adoption of notary fees regulation in RS	Baselines (2012): - cost of new single registration (LLC), includes costs of business registration, Official Gazette Publication, Court certificate, statistics number and tax registration receipt, receipt on VAT registration, average 3500 BAM in 2012; <sup>20</sup> - notary tariff on notary reward at 351BAM. - time to register business is 23 days - number of business registration procedures is 11	Target (end Q1 2015): - incorporation capital for newly established Ltd is 1 BAM - notary tariff on notary reward reduced by 30 percent. - time to register business is 3 days - number of business registration procedures is 5
Prior action #2 Government adoption and submission to Parliament of the final draft of the new Company Law in FBH	Baselines (2012): - cost of newly registered companies (LLC) in FBH in 2012 is 3.7 million BAM; and time cost 1.3 million BAM equivalent. - specific start-up notary tariffs in FBH for businesses at the range from 175 to 1000 BAM;	Target (end Q1 2015): - business registration start-up cost and time reduced by up to 20 percent - reduction in notary tariffs on aggregate up to 15 percent
Prior action #3 Enactment of the Law on Changes and Amendments to the Business Registration Law and adoption of regulation to reduce notary tariffs in FBH.		

<sup>20</sup> This is a cost estimate calculated by an inter-institutional Task Group established by RS Government to prepare a regulatory impact assessment of Business Registration process in RS. The document has been verified and officially adopted by RS Government.

***Pillar 2 – Streamlining Investment Procedures in Inspections and Construction***

<p>Prior action #4 Enactment of the new Inspections Law in FBH</p>	<p>Baseline (2012) - average number of certificates issued per day is 311  - direct costs for businesses based on frequency of visits without the risk-based inspections is 9mln BAM</p>	<p>Target (end Q1 2015): - average percent<sup>21</sup> of increased certificates per day is at least 15 percent (increased effectiveness) Target (end Q3 2015) - direct costs for businesses based on frequency of visits with the risk-based inspections is reduced by at least 10 percent</p>
<p>Prior action #5 Enactment of the Spatial Development and Construction Law and adoption of three accompanying rulebooks in RS</p>	<p>Baseline (2012) - time required for each individual permit (urban, construction and usage) is average 45 days - direct and indirect costs related to obtaining all construction related permits estimated at 180 mln BAM annually, based on actual frequency of requested permits in all cities and municipalities in RS</p>	<p>Target (end Q1 2015): - time required for each individual permit (urban, construction and usage) is up to 15 days - direct and indirect savings resulting from the new law are estimated at 17 million BAM annually for the businesses.</p>
<p align="center"><b><i>Pillar 3 – Simplifying Processes of Cross-Border Trading</i></b></p>		
<p>Prior action #6 Adoption of regulations (rulebooks) to streamline export/import procedures in FBH</p>	<p>Baselines (2012), based on actual frequency of company requests for export/import permits: Costs: 9.3 mln. BAM Time 9.9 mln. BAM equivalent</p>	<p>Target (end Q1 2015):  Reduction of business cost and waiting time costs and time for licensing, permits and approvals, related to import/export procedures for 7<sup>22</sup> key export sectors, by a one-off up to 5 percent reduction in total over both entities (2 million BAM<sup>23</sup>).</p>
<p>Prior action #7 Adoption of regulations (rulebooks) to streamline export/import procedures in RS</p>	<p>Baselines (2012), based on actual frequency of company requests for export/import permits: Costs: 8.8 mln. BAM Time 19 mln. BAM equivalent</p>	

<sup>21</sup> Based on introduction of the new sampling regime prescribed by the new Law.

<sup>22</sup> Wood processing; fruits and vegetables; meat and meat processing; basic materials; dairy; and electrical appliances and metal processing.

<sup>23</sup> Target based on the Compliance Cost Savings methodology (CCS). This methodology is a one-sided view of the reforms' benefits to the private sector providing an indication of the resulting extra resources that private businesses may use, at least in part, to expand their businesses or make new investments.

Annex 2: LETTER OF DEVELOPMENT POLICY

BOSNA I HERCEGOVINA  
MINISTARSTVO FINANCIJA/  
FINANSIJA I TREZORA



БОСНА И ХЕРЦЕГОВИНА  
МИНИСТАРСТВО ФИНАНСИЈА  
И ТРЕЗОРА

BOSNIA AND HERZEGOVINA  
MINISTRY OF FINANCE  
AND TREASURY

Mr. Jim Yong Kim  
President  
The World Bank  
1818 H Street, N.W.  
Washington, D.C., 20433

August 26, 2014

**REF: Letter of Development Policy  
Bosnia and Herzegovina Business Environment Development Policy Loan**

Dear Mr. Kim:

This is to request, on behalf of Bosnia and Herzegovina (BH), a Business Environment Development Policy Loan of US\$ 50 million to support our economic reform program. This draft letter presents the general background and summarizes critical aspects of the program that the authorities of are committed to undertake over the short and medium term to implement reforms for improvement of the business environment and sustainability of economic growth and jobs.

**Macroeconomic framework**

Authorities in BH remain focused on ensuring sustainable economic growth and financial stability, and supporting a better business environment. Five years after the crisis began, its lingering effects are still visible but the latest indicators suggest a modest economic recovery in 2013, primarily supported by exports. The currency board continued to support monetary stability and inflation remained low throughout 2013. Industrial production and manufacturing grew indicating a revival in the manufacturing sector, supported by export growth, with goods exports up by 8.7 percent in 2013. Overall, economy is estimated to have grown by 1.8 percent in 2013 and contract by 0.7 percent in 2014 due to recent floods.

The impact of the recent floods on the BH economic activity is placing additional pressure on an already weak economic recovery. Bosnia and Herzegovina's (BH) economy performed poorly in recent years due to weak internal and external economic environments but a surge in exports supported a modest economic recovery in 2013. Industrial production picked up by 6.4 percent in 2013 with manufacturing growing by 9.7 percent and intermediate goods by 4.7 percent. Inflation remained low in 2013 and at the end of the year BH experienced deflation. Internal and external risks to the recovery remained, including a high unemployment rate (27.5 percent) and a slow recovery in the EU. Even though a surge in exports supported modest growth, a slow recovery in the EU could hurt export growth, and a slow-down in fiscal revenues, impacting the 2014 budget.

Damages and losses from the floods are estimated to have cost the equivalent of nearly 15 percent of GDP. Ensuring the sustainability of the fiscal framework is the key to macro-economic stability. We began fiscal consolidation in 2010 and reduced the fiscal deficit to 2.6 percent in 2012 (in line with the IMF program requirements) from 5.5 percent of GDP in 2009. Hence, even before the floods BH was facing significant fiscal challenges exacerbated by declining revenues. To maintain a sustainable fiscal stance in the face of declining revenues, the authorities took some measures to reduce expenditures. The floods are expected to put further strain on public finances, bringing the fiscal deficit to 4.5 percent of GDP in 2014. Given the state of public finance in BH, there is little fiscal space to address even the most urgent humanitarian needs. Therefore the fiscal consolidation will have to be on hold in the near term as revenues are expected to fall and spending needs are increased as a result of the recent floods.

The authorities will work at ensuring sustainability of the fiscal framework as a pre-requisite to macro-economic stability. The authorities have an ongoing dialogue with the IMF team and full support of the direction in which reforms are going. We are taking a conservative approach to revenue estimation and have based our budgets on revenue forecasts below those of the IMF. Following the floods, with little room to raise further financing from domestic markets, external financing needs have increased to an estimated 4.6 percent of GDP. Some potential sources of financing have been identified to partially close this gap while additional financing sources (1.7 percent of GDP) are expected to be secured from the funds raised at the recently held Donors' conference organized in Brussels on July 16, 2014. We very much appreciate the World Bank's fast approval of the US\$100 million Emergency Recovery Loan, which together with the US\$50 million for this development policy loan will provide material help during these difficult times. The implementation of necessary fiscal measures and structural reforms will be underpinned by a strong partnership which we are seeking with the World Bank and the IMF in the remaining of the year. We are committed to work on implementing the additional structural reforms which will bring the country closer to a fully functioning market economy in the medium term.

### **Program of Reforms in the Business Environment**

Our commitment is to transform BH into a fully functioning market economy with a vibrant private sector. BH's business environment is considered to be lagging behind its neighbors, with the latest Doing Business ranking at 131. Reforms that are currently being carried out and supported by this operation make it possible to respond and restructure the business environment, improving the governance and efficiency of the public administration while ensuring conditions are created to nurture private sector development and growth.

#### Facilitating Business Start-up

Our main objective of this set of reforms is to address the critical issues impeding business creation. The time and costs for starting a company have not improved evenly across BH in a long while, making BH the least business friendly country in the region. To this effect, the entity governments initiated reforms that will enable quicker and more affordable business registration. RS initiated a two-phased approach for establishing a One-Stop-Shop (OSS) for business registration. Phase 1, the subject of this operation, involves legislative reform to cut the cost and time of starting a business by more than 50 percent. The reform involves changing a package of 13 different laws and regulations, most notably the Business Registration Law, Law on Agency for Intermediary, IT and Financial Services, Company



Law, Law on Court Taxes and Fees and Law on Administrative Taxes, and changing Regulation on Notary Fees. The laws have already been adopted, and the RS has proceeded to Phase 2 with establishing the OSS on December 1, 2013. The reform process significantly decreases the number of necessary procedures for starting a business in the RS. In parallel, the FBH prepared the new Company Law, introducing modern corporate management practices, streamlined and improved registration policies, reduction in capital requirements, and associate enterprises practices. The Company Law is in its final adoption stage. The FBH is committed to enact the law as soon as possible, the latest during August 2014. In addition, FBH amended the Business Registration Law to enhance the registration process and reduce registration costs by 50 percent.

#### Streamlining Investment Procedures in Inspections and Construction

The inspections and construction regimes are greatly influencing the functioning of our economy. FBH has embarked on inspections reform, given its significant impact on businesses and the EU accession. Vertical coordination in official controls has become a critical element in the overall system of requirements that BH must meet in order to be able to export to EU. Additionally, FBH is committed to the introduction of risk-based inspections, certification of inspectors, and organizational changes aimed at improving its service to the private sector. Risk-based inspections alone is expected to yield up to 10% savings for the businesses.

The Doing Business 2014 report ranks BH at 175th place on obtaining construction permits, with 17 procedures, 170 days, and at a cost of 1,100 percent of income per capita. The RS therefore prepared a new construction law introducing risk-based approach and streamlined and cost efficient procedures. The Law provides for faster and more efficient administrative processing of major infrastructure projects. The process and documentation for issuing construction and usage permits have been streamlined, and the timeline for obtaining both types of permits is not going to exceed 15 days irrespective of building size. The RS government estimates that this will enable up to BAM 17 million savings annually for businesses.

#### Simplifying Processes of Cross-Border Trading:

FBH development strategy and RS economic program clearly define commitment and focus towards improvement of framework aimed at strengthening openness of BH's economy. Bearing in mind the divided competencies between state and entities, the import/export procedures represent a burden for the business community due to the unclear requests for documentation, time and costs needed to address any issue. The authorities are therefore carrying out measures aimed at improving the import/export procedures by simplifying procedure, reducing the necessary steps, defining numbers and forms of the necessary documentation, and defining the manner in which fees are determined. This reduction of direct and indirect costs to obtain licenses, permits and approvals, related to import/export procedures for seven key exports (wood; fruits and vegetables; meat; basic materials; dairy; electrical appliances and metal), is estimated to amount to a one-off 4 percent (2 mln BAM) for both entities.

## **Future considerations**

The authorities are committed to improve business environment and attract more investment in BiH. In order to achieve higher investments, there is a high degree of commitment to a series of medium term reforms aimed at improving investment climate and enabling investments and re-investments, creation of common economic space in BH and level playing field for investors by reducing costs of business entry and operations in BH, and enabling faster corporate restructuring of private enterprises and putting unproductive assets into productive use for investors.


The authorities will work together on furthering these reforms in the medium term. They are therefore committed to further improve the business environment and are planning to advance the following reforms:

- i) Harmonized quality control of imports and exports applicable throughout BH, ensuring harmonized procedures, goods and processes for imports and exports on any border crossing in BH.
- ii) Streamlining and improving business registration and creating a transactional E-Registration platform(s) for ease of registration. To enable this, preparations for E-Signature platforms will have to proceed in both entities.
- iii) Improvement in inspections and their closer alignment with EU practices through full implementation of risk-based inspections, better sampling and controls, use of check lists and risk-planning, and capacity building of inspections in prevention and corrective actions.
- iv) Improving transfer pricing and tax related regulations. These reforms should enable faster entry and less burdensome operations in the country.

To unlock potential of unproductive assets and enable more agile and resilient private sector, entities will engage in improving corporate insolvency frameworks and related practices. Revisions of insolvency regulations and introduction of faster out of court settlements and pre-packaged bankruptcies, should enable faster corporate restructuring and putting unproductive assets into productive use. This would require revising entity level financial consolidation and restructuring regulations, as well as streamlining and speeding up court bankruptcy restructuring processes to ensure greater success of restructuring companies and making them viable. This would entail improving works of trustees and judges, as well as reducing costs of these operations.


Finally, works on improving entity contract enforcement and collection on delinquent contracts through faster court and out of court settlements and enforcement's will have to be completed.

Nikola Špirić

  
Minister of Finance and Treasury

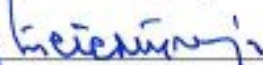


Ante Krajina

  
Federation BH Minister of Finance



Zoran Tegeltija

  
Republika Srpska Minister of Finance





## Annex 3: FUND RELATIONS

### IMF Executive Board Completes Sixth and Seventh Reviews Under the SBA for BH, Approves Euro95.7 Million Augmentation of the SBA and Euro191.4 Million Disbursement

Press Release No. 14/320  
June 30, 2014

The Executive Board of the International Monetary Fund (IMF) today completed the sixth and seventh reviews of BH's (BH) economic performance under a program supported by a Stand-By Arrangement (SBA). The Executive Board also approved an augmentation of the SBA by SDR 84.55 million (about Euro95.7million) to meet the country's urgent balance of payments need caused by severe floods in May 2014. The completion of the reviews and the augmentation enables a total disbursement of an amount equivalent to SDR 169.1 million (about Euro191.4 million), which will bring total disbursements under the arrangement to SDR 422.75 million (about Euro478.5 million).

The Board also granted the authorities' request for modification of the end-June 2014, end-September 2014, and end-December 2014 performance criteria on the fiscal balances (net lending) of the central government of the Federation of BH (FBH) and the Republika Srpska (RS) to reflect the impact of the natural disaster on government finances.

The 24-month SBA was approved on September 26, 2012 (see [Press Release No. 12/366](#)) and was extended for nine months and augmented by SDR 135.28 million (about Euro153.1 million) on January 31, 2014 to meet additional financing needs that arose mainly in late 2014 (see [Press Release No. 14/36](#)). The total arrangement will reach SDR 558.03 million (about Euro631.6 million, or 330 percent of quota) after the two augmentations.

Following the Executive Board's discussion, Mr. David Lipton, First Deputy Managing Director and Acting Chair, stated:

"The Executive Board expressed its regret at the major damage and hardship caused by the recent natural disaster that affected BH. The economy had been on a good track prior to the disaster, with growth picking up and external imbalances narrowing. The impact of the disaster has made the economic outlook more uncertain. Growth is expected to slow down appreciably and the current account deficit to widen substantially. The donor conference planned for mid-July will be critical to mobilize international donor support for the reconstruction.

"With fiscal consolidation having progressed largely as planned prior to the disaster, there is room for a temporary easing of fiscal policies to absorb the revenue losses and additional spending needs and avoid a further decline in activity. Nonetheless, to maintain public debt firmly anchored, it will be critical to strictly contain non-priority spending and sustain ongoing efforts to improve revenue collection.

"The authorities have adopted a well-coordinated strategy to assess and manage the impact of the disaster on the banking system. Continued progress in improving bank supervision and contingency planning, as well as the legal and regulatory framework for the banking sector in general and the resolution of non-performing loans in particular, will deliver a more resilient banking sector. Remaining shortcomings in the anti-money laundering framework will also need to be addressed.

"Renewed efforts to drive forward the structural reform agenda will be crucial to emerge from the disaster stronger, with faster growth and more jobs. Measures to facilitate business registration and operation are already yielding positive results, but more needs to be done to improve economic governance. Adopting new labor market legislation that is more conducive to job creation is essential to reduce the high level of unemployment.

"Given the authorities' performance and the additional financing needs created by the natural disaster, an augmentation of the Stand-By Arrangement is appropriate to smooth the adjustment process. The Arrangement remains a valuable anchor for economic policies during this uncertain and difficult period."

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# BOSNIA AND HERZEGOVINA

- ◻ SELECTED TOWNS
- ⊗ NATIONAL CAPITAL
- MAIN RIVERS
- MAIN ROADS
- RAILROADS
- ⋯ INTER-ENTITY BOUNDARY LINES
- - - INTERNATIONAL BOUNDARIES

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